7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

Sales of Nondeposit Investments

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed Interpretive Ruling and Policy Statement No. 05-1; with request for comments.

SUMMARY: The NCUA is proposing to adopt an Interpretive Ruling and Policy Statement (IRPS) on Sales of Nondeposit Investments. The proposed IRPS provides requirements, direction, and guidance to federally-insured credit unions on the establishment and operation of third party brokerage arrangements. The proposed IRPS updates and replaces NCUA's Letter to Credit Unions No. 150 on the sales of nondeposit investments.

DATES: Comments must be received on or before July 25, 2005.

ADDRESSES: You may submit comments by any of the following methods (**Please send comments by one method only**):

- NCUA Web Site: **http://www.ncua.gov/news/proposed_regs/proposed_regs.html**. Follow the instructions for submitting comments.
- E-mail: Address to **regcomments@ncua.gov.** Include "[Your name] Comments on Proposed IRPS (Sales of Nondeposit Investments)" in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

FOR FURTHER INFORMATION CONTACT: Paul Peterson, Staff Attorney, Office of General Counsel, at the above address or telephone: (703) 518-6540.

SUPPLEMENTARY INFORMATION:

A. Introduction

The NCUA Board is proposing to replace its Letter to Credit Unions No. 150 that contains NCUA's current guidance on the sale of nondeposit investments. NCUA issued Letter No. 150 in 1993. Since then, there have been several changes in law and regulation affecting the sale of nondeposit investments. NCUA is proposing to update this guidance, set out certain requirements, and provide additional information in the form of an IRPS. NCUA has selected the IRPS format for several reasons. First, an IRPS is more accessible to

credit unions and other interested parties than a Letter to Credit Unions. Second, an IRPS is an appropriate format for disseminating both guidance and requirements. Finally, NCUA does not seek public comment on Letters to Credit Unions but generally publishes an IRPS in proposed form with a request for public comment and, in this case, as certain provisions in the IRPS will have the force of regulation, the Administrative Procedure Act requires public notice and comment. Moreover, NCUA believes public comment on both the requirements and guidance in this IRPS will be very helpful, and NCUA encourages interested members of the public to provide their comments.

B. Background

Credit unions are organized to provide their members with financial services. While in the past credit unions limited member services largely to share accounts and loans, many credit unions now bring their members a full range of financial services. Some credit unions provide their members with investment options beyond share accounts, including: stocks, bonds, mutual funds, and variable annuities. These investment choices are collectively known as nondeposit investments.

Complex federal and state laws govern the creation and transfer of securities, and nondeposit investments, including insurance products sold with an investment component, are subject to securities laws. In particular, federal securities laws require that those who broker securities register with the U.S. Securities and Exchange Commission (SEC) and

comply with SEC regulations. Federal law defines a securities broker as any entity "engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. 78c(a)(4). The SEC interprets the concept of "effecting transactions" very broadly. Generally, the SEC considers not only those who buy and sell securities directly for others as securities brokers, but also those who relay instructions to buy and sell or who otherwise facilitate securities transactions and receive compensation related to the number or size of the transactions.

Credit unions cannot register as securities brokers. The requirements the SEC places on brokers, including capital and reserve requirements, are inconsistent with those that NCUA and state supervisory authorities place on credit unions. If credit unions wish to bring the option of nondeposit investments to their members, they must structure their involvement so that the SEC will not require them to register as brokers.

The most common method credit unions employ is the third party brokerage arrangement. In third party brokerage arrangements, a credit union can facilitate a brokerage firm that is properly registered and licensed with the SEC in selling securities. The SEC permits certain facilitating entities, including credit unions, to receive transaction-related compensation from the brokerage firm without subjecting them to broker registration requirements. In essence, the credit union brings the brokerage firm to its members, the members buy the securities from the broker, and the broker provides transaction-related remuneration to the credit union.

Third party brokerage arrangements can be either bilateral or multilateral. Bilateral arrangements involve an agreement between a credit union and a registered broker. The broker may or may not be a credit union service organization (CUSO). Multilateral arrangements involve an agreement between a credit union, an unregistered CUSO, and a registered broker. The SEC expects a CUSO to register as a broker if its activities rise to the level of "effecting the transfer of securities." Accordingly, a credit union and brokerage firm must limit the involvement of an unregistered CUSO in the sales of nondeposit investments.

.

Credit unions have limited powers so, in addition to compliance with securities laws, the nondeposit investment sales activities of credit unions must be authorized under their chartering statutes. Federal credit unions do not have the authority to sell nondeposit investments directly to their members. Under the incidental powers finder activity, however, a federal credit union may bring a third party vendor, the broker, to its members to offer them a financial service, the purchase of investments. 12 CFR 721.3(f). State chartered credit unions must look to their own state law for authority to engage in third party brokerage activities.

The antifraud provisions of applicable federal and state laws prohibit materially misleading or inaccurate representations in connection with offers and sales of securities. The broker

could face potential liability if members are misled about the nature of nondeposit investment products, including their uninsured status. The broker could also face potential liability for other improper sales practices, such as account churning or failing to evaluate the suitability of a particular nondeposit investment for a member.

While responsibility for proper sales practices falls on the broker, a credit union could also be liable if it fails to ensure that the brokerage activity is properly separated from the credit union's other activities, such as its deposit taking and lending. Complete separation of the credit union from the nondeposit investment activities is not possible because the sales are being offered to the member through the auspices of the credit union. The broker's sales representative, for example, will often be located on credit union premises, credit union employees may refer members to the sales representative, and credit union employees are permitted to provide literature about nondeposit investments to the member. The use of dual employee sales representatives, meaning an employee who works for both the credit union and the broker, may increase the legal risk to the credit union.

Credit union management must be aware of how the member will perceive the relationship between a credit union and the broker and how the two may be connected in the member's mind. The greater the possible connection, the more management must be involved in oversight of nondeposit investment sales practices. One federal court considered a case where an unsophisticated bank customer took out a mortgage loan to finance speculative securities purchases from the bank's third party broker. The court concluded that various

facts, including the use of a dual employee relationship, created a fiduciary relationship between the bank and the customer that the bank violated when it allowed the inappropriate mortgage and securities transaction to occur. *Scott v. Dime Savings Bank*, 886 F.Supp. 1073 (S.D.N.Y. 1995), *aff'd* 101 F.3d 107 (2d Cir. 1996), *cert. den.* 520 U.S. 1122 (1997). *See also Conte v. U.S. Alliance Federal Credit Union*, 303 F.Supp.2d 220 (D. Conn. 2004)(Existence or not of fiduciary relationship between credit union and member growing out of third party broker nondeposit investment sales is a factual question for the trial jury to decide).

NCUA's Letter No. 150, issued in 1993, contains NCUA's current guidance to credit unions on the sales of nondeposit investments. Several events since 1993 require that NCUA update the information in Letter No. 150. One change is NCUA's replacement of the Group Purchasing Activities rule with the Incidental Powers rule and the elimination of some restrictions on the compensation a federal credit union may receive from its finder activities. 12 CFR part 721.

Another change is a proposed Securities and Exchange Commission (SEC) regulation that would expand and clarify a credit union's authority to participate in third party brokerage arrangements without requiring the credit union to register as a broker. SEC Regulation B, 69 FR 39682 (June 30, 2004)(Proposed). Regulation B, when finalized, will replace current SEC guidance applicable to credit unions contained in a series of "no action" letters. *See, e.g.*, SEC Letter Re: Chubb Securities Corporation (Nov. 24, 1993). The SEC has not yet finalized Regulation B. If the final Regulation B differs materially from the

proposed Regulation B, the NCUA Board will make appropriate changes to the text of the final IRPS. The NCUA Office of General Counsel has also issued several legal opinion letters since 1993 interpreting various aspects of the sale of nondeposit investment sales.

Accordingly, NCUA has determined to update the guidance in Letter No. 150 and issue the update in IRPS form. NCUA believes that the IRPS is a better medium for the information than a letter to credit unions. The IRPS is more accessible, and is also appropriate for both mandatory requirements and guidance.

C. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires that NCUA prepare an analysis describing any significant economic impact agency rulemaking may have on a substantial number of small credit unions. 5 U.S.C. 601 et seq. For purposes of this analysis, NCUA considers credit unions under $10 million in assets as small credit unions. Since the binding requirements in this IRPS are generally restatements of requirements in other laws and regulations, NCUA does not believe this proposed IRPS will have a significant economic impact on a substantial number of small credit unions. NCUA invites the public to comment on this issue.

Paperwork Reduction Act

NCUA has determined that this proposed IRPS does not increase paperwork requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35) and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order.

This proposed IRPS applies to all credit unions, but does not have substantial direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this proposed IRPS does not constitute a policy that has federalism implications for purposes of the executive order.

By the National Credit Union Administration Board, on May 19, 2005.

_____

Mary Rupp

Secretary of the Board

Authority: 12 U.S.C. 1752a, 1756, 1757, 1766, 1783, 1784.

Proposed Interpretive Ruling and Policy Statement No. 05-1.

Sales of Nondeposit Investments

I. Introduction

This Interpretive Ruling and Policy Statement (IRPS) provides requirements, direction, and guidance to federally-insured credit unions offering their members nondeposit investments through third party brokerage arrangements. Among other things, this IRPS discusses the relationship between the credit union and the brokerage firm and the responsibilities of each, the separation of investment sales activities from the receipt of deposits or shares, contacts with members concerning securities sales, compensation and referral fees, the use of dual employees, sales to nonmembers, and related issues and concerns.

The information in this IRPS comes from a variety of sources, including the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), and

NCUA. This IRPS addresses the SEC's requirements and related guidance first. The IRPS concludes with additional NCUA requirements and guidance.

II. Purpose

This IRPS supersedes NCUA's Letter to Credit Unions No. 150, Sales of Nondeposit Investments. The information in this IRPS is intended to help credit unions conduct third party brokerage activities in a manner that is legal, protects members from potential securities fraud and abuse, and minimizes safety and soundness concerns for the credit union. The use of the word "must" in this IRPS reflects a legal requirement for credit unions. The use of the word "should" indicates guidance as to best practices.

III. Scope

The scope of this IRPS is sales of nondeposit investments to members through third party brokerage arrangements. This IRPS does not cover:

- No-load money market mutual fund transactions through a sweep account arrangement;
- Securities safekeeping activities, such as IRA custodianships;

- Nondeposit investment transactions for the credit union's own investment account; and

- Transactions in insurance products that do not include an investment component. Examples of these insurance products generally include whole life insurance and insurance sold in connection with loans.

IV. Conduct of Third Party Brokerage Arrangements: SEC Requirements.

Sales of nondeposit investments are subject to the securities laws and the regulation and oversight of the SEC. This section contains the SEC's regulatory requirements for the conduct of third party brokerage arrangements at credit unions. After each SEC requirement are additional direction and guidance from National Association of Securities Dealers (NASD) Rule 2350 and the NCUA.

SEC Requirement: The broker must perform brokerage services in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the credit union. The broker must clearly identify to members that it is providing the brokerage services, not the credit union. Any materials a credit union or broker uses to advertise or promote the availability of brokerage services under the arrangement must comply with federal securities laws. Advertising and promotional material must also clearly indicate that the brokerage services are being provided by the broker and not by the credit union. The credit union or broker must also inform each

customer that the securities being offered are not shares or other obligations of the credit union, are not guaranteed by the credit union, and are not insured by the National Credit Union Administration or any other federal agency.

Credit unions and the brokerage firms must market nondeposit investment products in a manner that does not mislead or confuse members as to the nature or risks of these uninsured products. To avoid member confusion about these products, credit union policies should specifically address the locations at which sales will take place. The best practice is that deposit-taking be physically separated from nondeposit sales functions.

The broker's sales representative must make complete and accurate disclosures to avoid the possibility that a member might confuse an uninsured investment product with an insured share account. When selling, advertising, or otherwise marketing uninsured investment products to members, members must be informed that the products offered:

- Are not federally insured;
- Are not obligations of the credit union;
- Are not guaranteed by the credit union or any affiliated entity;
- Involve investment risks, including the possible loss of principal; and
- If applicable, are being offered by a dual employee who serves both functions of accepting members' deposits and the selling of nondeposit investment products.

These disclosures must be clear and conspicuous, and the broker's sales representative must obtain a separately signed statement acknowledging the disclosures from members at the time a nondeposit investment account is opened. These disclosures must also be featured conspicuously in all written or oral sales presentations, advertising and promotional materials, prospectuses, and periodic statements that include information on both deposit and nondeposit products. Abbreviated versions of the disclosures may be used in certain advertising media as described in NASD Rule 2350.

The sales representative should also, when discussing nondeposit investments with a member face-to-face, display a sign, readily visible to the member, that states: "Investments sold here are NOT offered by the credit union, NOT guaranteed by the credit union, and DO NOT have any federal insurance. These investments may lose value."

To avoid confusion, brokerage firms should not offer investment products with a product name similar to the credit union's name.

SEC Requirement: Credit union employees who are not dual employees of the broker and the credit union may perform only clerical or ministerial functions in connection with brokerage transactions. Clerical and ministerial functions include scheduling appointments with the broker's sales representative, forwarding customer funds or securities, and describing in general terms the types of investments available from the credit union and the broker under the arrangement.

SEC Requirement: Only employees of the brokerage firm, or dual employees of the brokerage firm and the credit union, may receive incentive compensation for brokerage transactions. Other credit union employees may receive compensation for referral of members to the brokerage sales representative if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction. In this context, "nominal" generally means that the payment may not exceed the greater of twenty-five dollars or the wages the employee is paid for one hour of work.

The SEC's Regulation B indexes the maximum amount of a referral fee to inflation, so credit unions seeking to set referral fees as high as the SEC permits should consult with qualified counsel.

SEC Requirement: The credit union must have a written contract with any broker that offers brokerage services on the credit union's premises.

The credit union should also have a written contract with any brokerage firm that offers brokerage services through credit union mailings, emails or telephone calls made or sent by the credit union, or through the credit union's website.

V. Conduct of Third Party Brokerage Arrangements: Additional NCUA Requirements, Direction, and Guidance.

The SEC's regulatory requirements are primarily intended to protect the customer. This section contains additional guidance that is not dictated by or directly related to the SEC's requirements. Much of this guidance relates to the safety and soundness of the credit union.

Risks to the Credit Union.

As with any business activity, a credit union's directors must evaluate the risks associated with nondeposit investment activities. The risks include:

- *Legal Risk*: The credit union could be held liable for abusive sales practices perpetrated by nondeposit investment sales representatives.
- *Reputation Risk*: The credit union could be damaged by association with abusive sales practices, even if not liable for the practices.
- *Economic Risk*: The credit union could lose money if it commits itself to pay any expenses associated with the nondeposit investment activity and the sales and associated revenue are insufficient to pay those expenses.

Due Diligence in Selecting an Appropriate Brokerage Firm

Before entering into a third party brokerage arrangement, credit unions must take care to select an appropriate brokerage firm. For each firm under consideration, the credit union should:

- Ensure the firm can provide the services that credit union members need.
- Review the firm's financial statements and capital adequacy.
- Determine if the firm can adequately supervise its sales representatives at the credit union's location.
- Ask the firm to provide references, preferably other depository institutions, and talk with those references.
- Conduct background and NASD checks on the firm's principals and the sales representatives that will be working at the credit union.

Credit Union Policies, Procedures, and Contracts.

The credit union must adopt written policies and procedures concerning the brokerage arrangement. Many of these policies and procedures should be reflected in the contract with the brokerage firm. At a minimum, the policies, procedures, and contracts should address:

- *The features of the sales program*. Credit union policies should describe the types of products that a broker may offer through the third party brokerage arrangement. For all products, the credit union should identify specific laws, regulations, and any other limitations or requirements, including qualitative considerations, that will expressly govern the selection and marketing of products a broker may offer. Qualitative considerations include an analysis of the level of complexity and volatility in the investments that you will permit the broker to offer your members.

- *A description of the relative responsibilities of the credit union and the brokerage firm.* The credit union's policies and the contract between the brokerage firm and the credit union must make clear that the brokerage firm is primarily responsible for ensuring that the nondeposit sales function is conducted in compliance with all applicable laws, regulations, and policies. The contract should, however, recognize that the credit union has the right to check for compliance and may access member accounts for verification and oversight.

- *Indemnification by the brokerage firm.* Credit unions policies should require a specific and unambiguous contractual agreement from the brokerage firm to indemnify the credit union for any monetary damages arising from nondeposit sales activities, including but not limited to improper sales practices.

- *The roles of credit union employees*. Credit union policies should describe the roles of credit union employees in nondeposit investment sales and the limits on their activities. The limits and compensation for referrals must be consistent with SEC requirements.

- *The roles of brokerage firm employees*. Credit union policies should require the brokerage firm to provide the credit union with a written document that explains the duties of its sales representatives and gives the credit union the names, contact information, and specific duties of those who will supervise the sales representatives.

- *The location of nondeposit sales.* Credit union policies should describe where nondeposit sales may take place and how those sales will be separated from deposit-taking activities.

- *The use of credit union member information.* The credit union's policies should describe the information that may be transferred between the credit union and the brokerage firm or the brokerage firm's sales representative. The policies and contracts should describe how such information will be used and safeguarded and the associated privacy notices to members. The policies and contract terms must comply with NCUA's Privacy of Consumer Financial Information Rule and NCUA's Security Program Rule. 12 C.F.R. Parts 716 and 748. The brokerage firm must agree in writing to comply with the credit union's policies on information practices.

- *Termination of the contract.* The contract should contain a provision that permits the credit union to terminate the contract for both cause and for the convenience of the credit union. Failure by the brokerage firm to adequately supervise its sales representative should be included as a specific for-cause reason for contract termination.

- *Compliance with the requirements in this IRPS and applicable law and regulation.* Credit unions must maintain programs to monitor compliance by the broker, its salespeople, and other entities involved in the sales of nondeposit investments. Credit union personnel performing the compliance function should be independent of any credit union personnel involved in investment product sales and management. At a minimum, the compliance function should include a system that monitors member complaints; ensures supervisory personnel at the broker make scheduled examinations of their sales personnel; and contacts members that have purchased nondeposit investments to ensure they received and understood the required disclosures. Compliance personnel should also conduct periodic, random samplings of account activity to look for evidence of abuse. When conducting sampling, compliance personnel should look for evidence such as:

    - Accounts with a high rate of investment turnover, which may indicate the sales representative is churning accounts to generate commissions;

    - Accounts with complex investments that may be unsuitable for the particular member; and

    - A combination of loan accounts and nondeposit investment accounts that might indicate a member borrowed large sums of money from the credit union to finance nondeposit investment purchases.

Credit unions should consult with qualified counsel for further information about what to review when examining member accounts. The intensity of the credit union's compliance effort will depend on the nature and extent of nondeposit investment sales,

evidence of the effectiveness of the broker's compliance systems, and the level of member complaints. Whether the credit union can obtain an unambiguous indemnification agreement from the brokerage firm should also affect the intensity of the compliance effort.

The Use of Dual Employees.

Credit unions may establish a third party brokerage arrangement using dual employees. These arrangements create additional risk for the credit union and must be designed, operated, and monitored carefully.

- *Separation of duties*. A dual employee should have separate, written job descriptions for the duties performed for the credit union and the nondeposit investment sales duties, which are performed for the brokerage firm. The duties performed for the credit union should be unrelated to the sale of nondeposit investments. The duties performed for the credit union should not bring the employee into contact with members that might also purchase nondeposit investments. The dual employee should have no management or policy-setting responsibilities within the credit union related to nondeposit investments.

- *Separation of employment descriptions when interacting with members*. The dual employee should not use any materials that could potentially confuse a member as to the capacity in which the dual employee is functioning. For example, dual

employees should use separate business cards for their credit union and nondeposit investment sales functions. Likewise, dual employees should use separate stationary for nondeposit investment correspondence and credit union correspondence and, when conducting nondeposit investment business, dual employees should not reference their positions at the credit union. .

- *Dual employee compensation*. The compensation a dual employee receives for nondeposit investment activities may be paid directly by the broker to the employee. Alternatively, the broker may reimburse the credit union for the employee's nondeposit investment activities. The credit union's records and the periodic earnings statement provided to the employee should indicate how compensation is divided between nondeposit investment work and work for the credit union. A dual employee should also have written agreements with the two employers establishing the amount of each employer's compensation to the employee.

- *Indemnification*. The use of dual employees increases the risk a credit union may be held liable for abusive sales practices. At the same time, the brokerage firm may have less incentive to supervise nondeposit sales activities properly when conducted by a dual employee. Accordingly, the credit union should seek an indemnification agreement from the brokerage firm as described above. The credit union should also seek fidelity bond coverage or additional insurance for any credit union liability arising from employee misconduct related to the nondeposit investment function.

Sales of Nondeposit Investments to Nonmembers.

Because credit unions may only provide services to members, a credit union may generally only accept income and pay expenses associated with nondeposit investment sales to its members. NCUA realizes, however, that in some cases it may be difficult for a credit union to connect particular income to a transaction involving a member. For example, some sales representatives may have generated sales that occurred before the representative joined the brokerage arrangement. These representatives may bring with them a stream of trailer income that cannot now be associated with any particular person or is not otherwise attributable to members of the credit union. A similar situation may arise in brokerage arrangements involving multiple credit unions working with one broker and sales made to members of the various credit unions.

To address these situations, NCUA will allow a credit union in a third party brokerage arrangement to accept a *de minimus* amount of income that is not directly attributable to sales to its members. In this context, *de minimus* means that the ratio of income not directly attributable to members to the total gross income the credit union receives under the arrangement cannot exceed five percent.

A similar issue may arise if a credit union pays expenses associated with the sales of nondeposit investments. NCUA will allow a credit union in a third party brokerage

arrangement to pay a *de minimus* amount of expenses associated with the sale of nondeposit investments to nonmembers. In this context, *de minimus* means that the ratio of nonmember sales expenses paid by the credit union to the total expenses paid by the credit union under the arrangement cannot exceed five percent.

VI. Applicable Law and Regulation

- The Federal Credit Union Act, 12 U.S.C. §1751 et seq.
- The Securities and Exchange Act of 1934, §3(a)(4), 15 U.S.C. §78a et seq.
- Regulation B, Securities Activities of Banks and Other Financial Institutions, 15 C.F.R. §§242.710 et seq.
- NASD Rule 2350, Broker/Dealer Conduct on the Premises of Financial Institutions.
- NASD Rule 3040, Private Securities Transactions of an Associated Person.